Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Alpert	Analyst:	Marion Mann DeJong	Bill Number:	SB 1571
Related Bills:	See Legislative History	Telephone:	845-6979	Amended Date:	03/22/2004
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Coordination of U.S. Source Income & Subpart F Water's-edge Partial Inclusion

SUMMARY

This bill would modify the statutes regarding Subpart F and U.S.-source income to:

- specify that a controlled foreign corporation (CFC) that is a California taxpayer or that has income from a U.S. source cannot exclude its Subpart F income from a water's-edge combined report;
- coordinate existing laws so that the U.S.-source income rules and the Subpart F income rules would operate simultaneously and apply consistently to corporations regardless of whether they are California taxpayers; and
- require the Franchise Tax Board (FTB) to issue regulations to resolve problems relating to potential double taxation of U.S.-source and Subpart F income.

SUMMARY OF AMENDMENTS

The March 22, 2004, amendments added an operative date and legislative intent. This is the department's fist analysis of this bill.

PURPOSE OF THE BILL

The purpose of this bill is to reduce taxpayer confusion and eliminate unintended opportunities for tax avoidance.

EFFECTIVE/OPERATIVE DATE

The bill specifies that it would apply to taxable years beginning on or after January 1, 2004.

POSITION

Support.

On December 2, 2003, the Franchise Tax Board voted 2-0, with the representative of the Department of Finance abstaining, to sponsor this legislation.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
_______ SA	_______ O	_______ NAR	Gerald H. Goldberg	3/29/04
_______ N	_______ OUA	___X___ PENDING		

ANALYSIS

BACKGROUND

AB 1469 (Ortiz, 1997/1998) contained proposed amendments to existing water's-edge provisions to address the first problem described, below, in "State Law." Governor Wilson vetoed AB 1469 because of that provision. In his veto message, Governor Wilson stated that the water's-edge provision was added to the bill late in the legislative session with little or no policy debate, it could have a negative effect on the California business community, and it had the potential to result in a tax increase.

Analyses of AB 1469 by Capitol staff described the bill as addressing an unintended "loophole" in existing law. Department staff assigned no revenue gain to AB 1469 since, at the time, no taxpayer had been identified utilizing the interpretation of law that the bill would have precluded. Opponents of AB 1469 asserted that the bill would change an agreed-upon compromise made when the water's-edge election was adopted and that the bill would result in a tax increase.

In 2002 department staff developed a legislative proposal, LP 03-22, which was almost identical to this bill. At its November 26, 2002, hearing, the Franchise Tax Board took no action on LP 03-22. Controller Connell suggested that the department work with industry to develop a mutually acceptable solution to the whole range of water's-edge, CFC (LP 03-23), and Subpart F subjects.

Department staff held a meeting with industry representatives in October 2003. Industry representatives did not express concerns with the substance of LP 03-22, but stated a preference for staff to develop a broader proposal, namely changing the conceptual approach from California's method of taxing a CFC to one conforming to federal law that would treat Subpart F income as a deemed dividend distribution. They also recommended that such an approach include a revenue neutral dividends received deduction.

Department staff agrees that a change in the conceptual approach to the federal method of treating Subpart F income as a deemed dividend with a revenue neutral dividends received deduction is appropriate. However, because of the uncertainty relating to the dividends received deduction created by the *Farmer Bros* litigation ((2003) 108 Cal App 4th 976, cert. denied, (2004) 158 L.Ed.2d 79), staff believes that such a proposal should be deferred until resolution of the dividends received deduction issue is reached. Once that issue is resolved, department staff will work with industry on a proposal to change the conceptual approach of taxing CFCs.

Staff believes that this bill is necessary because there is indication that taxpayers are beginning to use the inconsistency within the statute to avoid including CFCs with Subpart F income in the water's-edge combined report. Further, even if the conceptual approach of taxing CFCs were changed, it would occur over a period of up to seven years to allow a taxpayer currently filing on a water's-edge basis to file under existing rules until the term of the contract expires. Thus, the issue in this bill would still need resolution during that seven-year period.

FEDERAL LAW

To understand this bill it is necessary to understand the general federal rules for taxing corporations. Under current federal law, a corporation organized in the U.S. is taxed on all its income, regardless of source, and is allowed a credit for any taxes paid to a foreign country on its foreign-source income.

A foreign corporation engaged in a U.S. trade or business is taxed applying U.S. graduated corporate income tax rates on the net income effectively connected with the conduct of that business in the U.S. This is known as effectively connected income (ECI). In addition, a foreign corporation is generally taxed at a flat 30% rate on specified types of fixed, determinable, annual, or periodic income (usually investment income) from U.S. sources. The income of a foreign corporation can be composed of either U.S.-source income or foreign-source income or both.

A U.S. corporation can operate in foreign countries itself, through branches, or through foreign subsidiaries. These foreign subsidiaries are known as CFC's. A CFC's income would normally not be taxed by the U.S. until it flows back to the U.S. parent corporation through dividends. In the 1960's it was determined by Congress that CFC's were being used to shield certain income, called "tax haven income," from U.S. taxation. As a result, Subpart F was added to the Internal Revenue Code. Under Subpart F, certain income is treated as being paid to the U.S. shareholders as a deemed dividend immediately upon being earned, which allows the U.S. to immediately tax the income when the CFC earns it and prevents deferral of tax.

A foreign corporation that is a CFC can be engaged in a U.S. trade or business or hold securities issued by a U.S. corporation. In such circumstances, a foreign corporation has both U.S.-source income and Subpart F income. In addition, some items of income (e.g., interest from U.S. Treasury Bonds) can qualify both as U.S.-source and Subpart F income. To the extent that a foreign corporation has an item of income that is both U.S.-source and Subpart F income, the income generally will be subject to both the U.S.-source rules and the Subpart F income rules.

It is important to note that effectively, 100% of a foreign corporation's income that meets the definitions of either U.S.-source income or Subpart F income is taxed. This is accomplished because the federal statutes coordinate the U.S.-source and Subpart F income rules so that both sets of rules operate simultaneously and apply to a single corporation. However, the same item of income is taxed only once.

STATE LAW

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine their income on a "water's-edge" basis. Generally, under water's-edge an entity incorporated in the U.S. is included in the combined report while a foreign entity is excluded. The law also provides specific rules about whether certain types of entities are included in or excluded from the water's-edge combined report, including the following two rules.

1. Any affiliated corporation that is a CFC for federal tax purposes is partially included in the water's-edge combined report. In general, the income and apportionment factors of the CFC are included based on the ratio of the CFC's Subpart F income for federal purposes for the current year to the CFC's earnings and profits (E&P) for the current year. The ratio can be 0% or higher. However, it cannot exceed 100%.

2. Foreign corporations with less than 20% of their activities in the U.S. and foreign banks are included in the water's-edge combined report, but only to the extent of their U.S.-source income.

This bill deals with two problems in current state law regarding the taxation of CFCs. See Appendix I for a diagram of these problems.

First, there is a possible inconsistency in the statute that could be interpreted to exclude certain CFCs from the water's-edge group. (See Appendix II.).

Generally, CFCs are not California taxpayers. However, a water's-edge group could cause its CFC to become a California taxpayer by either qualifying with the Secretary of State or establishing minimal ties in California sufficient to create nexus and a minimum tax liability. While department staff interprets the statute to require any CFC to be partially included in the water's-edge combined report under rule No. 1[1], some taxpayers argue that if a CFC is a California taxpayer, the income is limited to its U.S.-source income under rule No. 2. Thus, some taxpayers argue that such a CFC should pay only the $800 minimum franchise tax and consequently exclude Subpart F income from the water's-edge combined report.

In addition, some taxpayers argue that even a small amount of U.S.-source income (e.g. stock or a debt instrument of a U.S. corporation) causes its included income in the combined report to be limited under rule No. 2 "to the extent of" its U.S.-source income and apportionment factors.

Second, current law does not specify whether the U.S.-source income rules (rule No. 2) or the Subpart F income rules (rule No.1) are applied to income of a CFC that qualifies as both U.S.-source income and Subpart F income (e.g. interest income). However, California Code of Regulations Section 25110(d)(2)(H) provides that the U.S.-source income rules apply when both rules could apply. If the same income item were both Subpart F income and U.S.-source income, the regulation would treat that *item* of income as U.S.-source income rather than Subpart F income.

Since the U.S.-source and Subpart F rules are not coordinated as they are under federal law, some taxpayers have argued that California law and the regulation provide that if a CFC has an item of U.S.-source income and a separate item of Subpart F income, that the U.S.-source income causes the Subpart F rules to no longer apply and the Subpart F income escapes taxation.

For example, assume a CFC had total net income of $4 million. Of the $4 million, $200,000 is U.S.-source income and $3 million is Subpart F income. Assume that the $200,000 U.S.-source income also qualifies as Subpart F income. Taxpayers have argued that the Subpart F income rules would not apply and only the $200,000 U.S.-source income would be included in the water's-edge combined report. Department staff has interpreted the law and regulation to work to prevent double taxation of the income so that $2,800,000 ($3 million Subpart F income less the amount included under the U.S.-source income rules) would be included under the Subpart F rules and $200,000 would be included under the U.S.-source rules.

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[1] It is department staff's opinion that the provisions of Section 25110(a)(6), which include "any" affiliated CFC, is broad enough to require inclusion of all CFCs in the combined report, regardless of whether they are California taxpayers. Further, the rules of statutory construction would favor the inclusion of CFCs because presumably the legislature would not create a law including CFCs in the water's-edge group that could be avoided simply by becoming a California taxpayer or generating a minimal amount of U.S.-source income.

THIS BILL

This bill would specify that a CFC that is a California taxpayer or has income from a U.S. source cannot exclude its Subpart F income from a water's-edge combined report. Although some taxpayers may disagree, department staff believes this is a clarification of existing law.

This bill also would coordinate the U.S.-source income and the Subpart F income rules to operate simultaneously. Thus, like federal law, 100% of the corporation's income that is U.S.-source and 100% of its Subpart F income would be considered in the combined report for California tax purposes. The rules would apply regardless of whether the entity is a California taxpayer. In addition, this bill adds a requirement that FTB prescribe regulations to prevent the double counting of income and factors when a corporation has both U.S.-source and Subpart F income.

IMPLEMENTATION CONSIDERATIONS

This bill could be implemented in the department's annual program updates.

OTHER STATES' INFORMATION

Other states have variations on the rules for apportionment of income of the activities of multinational corporations conducted in foreign countries. However, no other state taxes on a water's-edge basis similar to California. Thus, it does not appear that these issues apply to other states.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

If this bill simply clarifies existing law, there would be no revenue impact. However, taxpayers assert that under their interpretation of existing law, they have been allowed since 1988 to create sufficient nexus to cause their CFCs to become California taxpayers and avoid including otherwise includible Subpart F income. To date, relatively few taxpayers have been identified as asserting a nexus or other position for excluding Subpart F income. The total revenue at risk is uncertain, perhaps a few million annually currently, but could reach $50 million annually in the near future if the taxpayer's position is sustained. This projection is based on a prior examination by audit staff of corporations with prominent CFCs.

Revenue Discussion

Under the taxpayers' interpretation, the number of CFCs that establish ties in California sufficient to create nexus, and any otherwise includible Subpart F income and apportionment factors, would determine the revenue impact of this proposal. Removing CFC dividends from the calculation of the inclusion ratio (used to determine includable Subpart F income) has been previously estimated, through an examination of tax returns, at $25 million annually. Departmental staff estimates that this loss is roughly half of the loss attributed to excluding all Subpart F income.

ARGUMENTS/POLICY CONCERNS

- This proposal would eliminate taxpayer confusion and eliminate unintended opportunities for tax avoidance.

- Some taxpayers may actively oppose this bill. Opponents have contended that since the enactment of the water's-edge legislation they have been allowed either to qualify as a foreign affiliate or to create sufficient nexus for that affiliate to cause a CFC to become a California taxpayer and thereby avoid the inclusion of Subpart F income. Under this interpretation, as a California taxpayer, the CFCs were liable for and paid only the $800 minimum corporation franchise tax and were not required to include Subpart F income within the water's-edge apportionable income base. Alternatively, taxpayers may argue that the mere presence of U.S.-source income would prevent the application of the Subpart F partial inclusion rule. Thus, they would argue, this proposal results in a tax increase.

  Under this view, the legislature's addition of income and apportionment factors attributable to Subpart F income of a CFC to the water's-edge combined report would be nullified by relatively simple tax planning. If so, the Subpart F provisions would be effective only as a tax trap for the unwary.

- In 1986, when defining the water's-edge group, the federal working group, which included legislative, government, and corporate participants, agreed that an effort should be made to (1) maintain a water's-edge group that was at least congruent with the federal consolidated return, and (2) include those activities and income which were generally recognized as tax-advantaged devices. An underlying principle was that to the extent possible, states should conform to the federal international taxation rules. This was generally to ensure that if the income of an entity was required to be taxed for federal purposes, the income and factors of that entity should also be included in the state return. In addition, conformity with federal law reduces the taxpayer's compliance burden. There is little rationale to justify circumventing the law requiring partial inclusion of a CFC merely because that CFC also has U.S.-source income or is a California taxpayer.

- Previously staff was only aware of a handful of taxpayers that were using the argument that their CFCs, although not incorporated in California, had nexus in California and were taxpayers in the year at issue and not required to include Subpart F income. Staff is now aware of a taxpayer that has actually registered its CFCs through the Secretary of State. This indicates that taxpayers may be beginning to register or qualify their CFCs in California in an attempt to avoid inclusion of their Subpart F income in the apportionable base. Staff is also aware of a taxpayer that included their CFCs with Subpart F income in their original return, but has filed a claim for refund to remove their CFCs with Subpart F income because the CFCs had U.S.-source income.

LEGISLATIVE STAFF CONTACT

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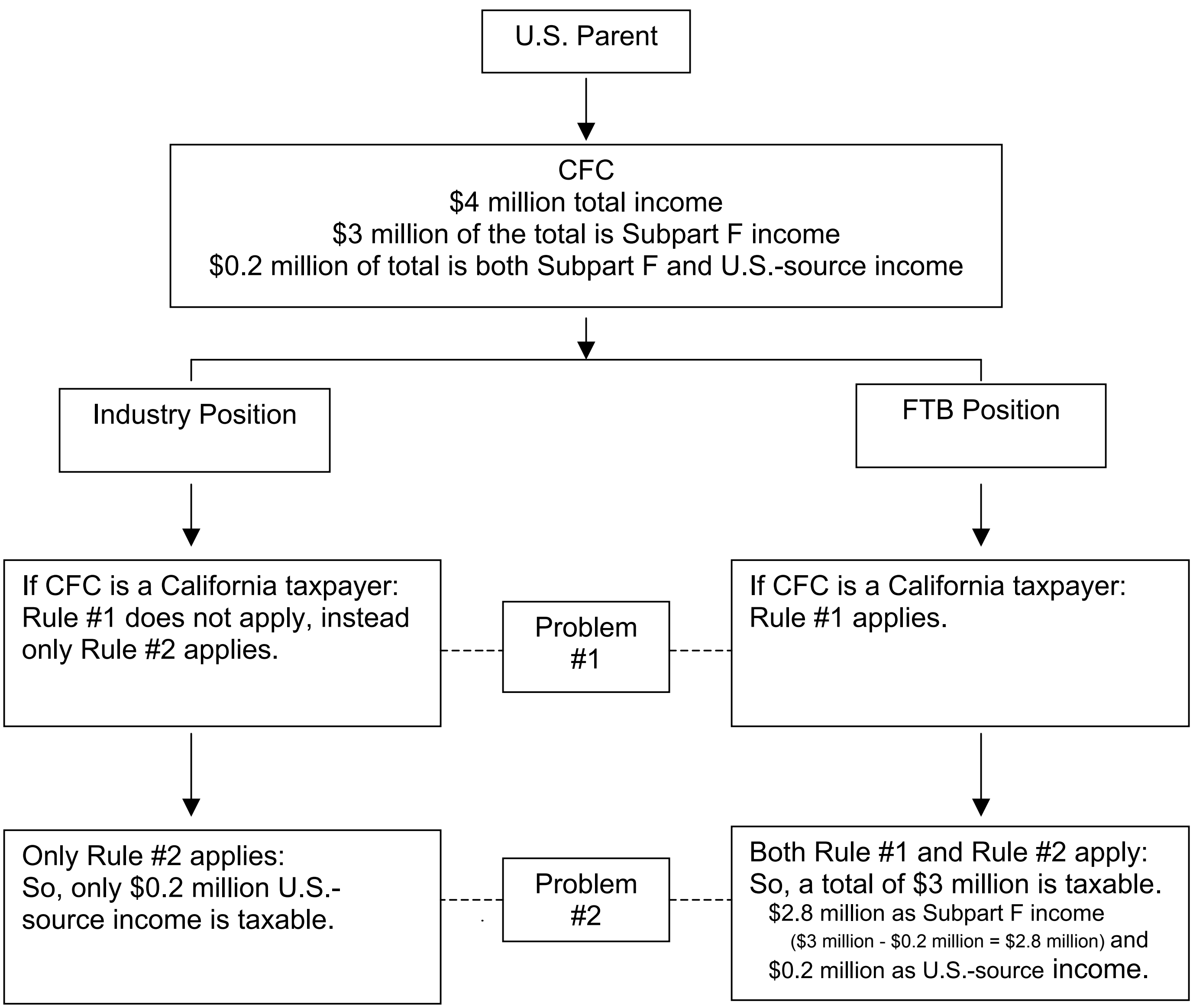
Appendix I

General rule, foreign corporations are excluded from the Water's-Edge group. Specific exceptions to general rule include:

- Rule #1 Controlled Foreign Corporations (CFCs) included in water's-edge group by ratio of Subpart F income/Earning and Profits (E&P).
- Rule #2 Foreign Corporation with less than 20% U.S. activities included in water's-edge group but only to extent of U.S.-source income.

Problem #1 If CFC is a California taxpayer what rule applies?
Problem #2 If CFC has both Subpart F income and U.S.-source income which rule applies?



Appendix II

A literal application of two different provisions of Revenue and Taxation Code Section 25110, subdivision (a)(6) and subdivision (a)(7)(B), yields two mutually inconsistent results. Under subdivision (a)(6), the income and factors of a Controlled Foreign Corporation (CFC) that is an affiliated corporation of a taxpayer that made a water's-edge election is included (to the extent of the Subpart F ratio) in the combined report of a taxpayer making a water's-edge election. Subdivision (a)(6), by its terms, applies regardless of whether the CFC is a taxpayer. Under subdivision (a)(7)(B), the income and factors of a CFC that is an electing taxpayer are included in the combined report for water's-edge purposes, but only to the extent of its income and factors attributable or assignable to U.S. sources, thereby arguably excluding Subpart F income from the income and factors of a water's-edge group.

As originally enacted in 1986 (operative for income years beginning on or after January 1, 1988), Section 25110(a)(7)(B) applied only to foreign banks and was included in the water's-edge legislation to clarify that a foreign bank would be included in a water's-edge combined report only to the extent of its U.S.-source income. Further, the ordering of the statute was such that the language of Section 25110(a)(7)(B) immediately followed the paragraph describing the U.S.-source income partial inclusion rules and before the paragraph describing the Subpart F income partial inclusion rules.

In 1988, the section was amended to change the term “bank” to “bank and corporation” so that if either a foreign bank or a foreign corporation had U.S.-source income, it could elect water's-edge and include income and factors in the combined report only to the extent of the U.S.-source income. In addition, the statute was renumbered so that Section 25110(a)(7)(B) now follows the paragraphs describing both the U.S.-source and the Subpart F partial inclusion rules.

A cardinal principle of statutory construction is to give effect to all of the provisions of a statute. Pursuant to the current provisions of Section 25110(a)(6), the income and factors of a CFC that is an affiliated corporation must be included to the extent of the Subpart F ratio within the combined report of a taxpayer making a water's-edge election. It is also clear that the provisions of subdivision (a), paragraphs (1) through (6) are limited to taxpayers with affiliated corporations. Subparagraph (7)(B), on the other hand, was enacted to permit a foreign taxpayer with no water's-edge affiliates to make a water's-edge election, taking into account its income and factors only to the extent of income derived from or attributable to sources within the U.S. and its factors assignable to a location in the U.S. Subparagraph (7)(B) was not intended to permit a CFC with Subpart F income to make an election and, for all practical and legal purposes, write the inclusion rules of paragraph (6) out of existence.

Nothing in the legislative record indicates intent to include CFCs to the extent of their Subpart F income while simultaneously allowing the same CFCs to shelter that income from inclusion in the combined report by becoming taxpayers.